1995 LEC TFP studies he had prepared for submission by USTA in the FCC's price cap performance review NPRM, CC Docket 94-1. Parties in the CPUC proceeding had the opportunity to cross-examine Dr. Christensen in a live hearing and also to serve Dr. Christensen directly with information requests concerning his LEC TFP studies. The information obtained through cross-examination and discovery of Dr. Christensen shed new light on problems with the underlying data and methodology used to develop Christensen's TFP results and on the process by which Christensen's "1993 Update" study was prepared.

First, key pieces of underlying data that had been revised in the 1993 Update cannot be independently verified, either in their original (May, 1994) or revised (January, 1995) incarnations. They are not "publicly available data" such as those included in LEC Form M reports or other public filings (e.g., ARMIS reports submitted to the FCC).[22] Two critical components of the capital index, i.e., the 1984 capital stock data and the telephone plant indexes (TPIs), fall in this category. With respect to the TPIs in particular, Dr. Christensen testified that "the TPIs are the most difficult of all these series to verify in that they are based on highly confidential information from the individual LECs."[23] For example, Dr. Christensen was asked specifically to explain the seemingly anomalous TPI for the Central Office Equipment (COE) plant category for Bell Atlantic, which had actually increased by 49% over the period 1984 to 1992, whereas the LEC composite TPI for COE had *decreased* by 7.3% over that same period.[24] Dr. Christensen conceded that the Bell Atlantic "data for TPI obviously looked different from those for other companies."[25] He explained that he had requested that Dr. Meitzen of his staff verify the accuracy of the TPI data with Bell Atlantic. He testified that, to his knowledge, Bell Atlantic did not provide any further information or data to support its assertion that the COE TPI values were an accurate reflection of prices that the company paid.[26] Moreover, Dr. Christensen also indicated that he would have no basis to know if Bell Atlantic's assertions were correct, because he did not look at Bell Atlantic's accounting records.[27]

With regard to the capital stock data, Dr. Christensen first indicated that the data was based upon original cost, which would come from actual accounting records, as opposed to

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22. California PUC, I.95-05-047, Transcript, September 27, 1995, at 197.

23. *Id.*, at 198.

24. USTA *ex parte* filing, CC Docket 94-1, February 3, 1995.

25. California PUC, I.95-05-047, Transcript, September 27, 1995, at 220.

26. *Id.*, at 219-220.

27. *Id.*

reproduction costs, which would be "an estimate of some sort."[28]   Dr. Christensen subsequently corrected his testimony, stating that, in fact, the capital stock data utilized in the Christensen/USTA studies reflected "reproduction cost, or the current cost of the capital stock as computed by each of the LECs," and admitted that such data "does not appear in the Form M."[29]   When asked if he knew how the reproduction costs for each of the capital stock figures were calculated, Dr. Christensen acknowledged that each of the LECs determined on their own what the current replacement cost would be and that he did not know the specific technology assumptions used by each of the LECs in calculating the reproduction costs.[30]   Nor could Dr. Christensen provide the specific details concerning the nature of the correction made by NYNEX that produced the $13.5-billion downward revision in the NYNEX 1984 gross base capital stock figure.[31]

As a general proposition, Dr. Christensen does not have documentation regarding how the various revisions incorporated in the data used in the 1993 Update Study were made. Dr. Christensen testified that he had no documentation regarding how the corrections took place or came about by the LECs, because it was the LECs who made the corrections.[32] Indeed, Pacific Bell's responses to information requests propounded by the California Committee for Large Telecommunications Consumers (CCLTC) indicate that Dr. Christensen was not provided with revised data from most of the nine LECs covered by his study until after December 19, 1994, or less than a month before USTA's submission of the 1993 Update Study to the Commission took place.[33]   Pacific Bell's responses to these same information requests also indicate Dr. Christensen "does not have any workpapers supporting the adjustment/corrections" and "Pacific Bell has been advised that to the extent that USTA has such workpapers, USTA is not authorized to release them."[34]   Furthermore, Dr. Christensen acknowledged that the information provided to the Commission by USTA in the February 3, 1995 *ex parte* filing identifying data differences between the USTA TFP Study submitted in May, 1994 and the 1993 Update submitted by USTA in January, 1995,

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28. *Id.*, at 227-228.

29. *Id.*, at 231.

30. *Id.*, at 233.

31. *Id.*, at 237; USTA *ex parte* filing, CC Docket 94-1, February 3, 1995.

32. *Id.*, at 209.

33. Pacific Bell Responses to CCLTC First Set of Information Requests, I.95-05-047, Nos. 12 and 12A.

34. *Id.*, Exhibit 8, Nos. VI and VII.

ECONOMICS AND
TECHNOLOGY, INC.

was not sufficient to verify the accuracy of the composite data used in the 1993 Update.[35] The information contained in USTA's February 3, 1995 *ex parte* filing provides individual LEC data only for those specific LECs for which data was revised; corresponding data for the other LECs, as well as data series for individual LECs that were not revised in the "1993 Update," have never been provided by USTA and specific requests for their production were refused by Pacific Bell. In order to replicate the composite data series used in the Christensen/USTA study, it would be necessary to have data for all data series for all nine of the LECs that were studied by Dr. Christensen.[36] According to Pacific Bell's responses to CCLTC information requests, individual company data "that is in the possession of either Dr. Christensen or USTA is subject to nondisclosure requirements and, therefore, cannot be provided."[37]

The lack of publicly-available and verifiable data underlying the 1993 revisions is of particular concern, given the circumstances surrounding the submission of the so-called 1993 Update. In particular, the 1993 Update would appear to have been motivated by the Bureau of Labor Statistics' (BLS) downward revision to the economy-wide productivity growth rate, announced in the summer of 1994, from 0.9% to 0.3%.[38] Under USTA's approach to calculating the X-factor (in which the input price differential between LECs and the economy as a whole is incorrectly assumed to be zero), the economy-wide productivity growth rate is subtracted from the LEC TFP measure. Thus, a reduction in the economy-wide productivity growth rate from 0.9% to 0.3% produces a 0.6% increase in the X-factor, worth approximately $1.5-billion in revenues to the LECs over the next four years.[39] As testified by Dr. Christensen, the Bureau of Labor Statistics revised its estimate of economy-wide productivity growth in the summer of 1994. However, neither Dr. Christensen nor USTA filed any revisions to the May 1994 study to reflect the BLS change until January 20, 1995, with their submission of the 1993 Update which *also* incorporated the revised data that Dr. Christensen had received from the LECs. Use of the revised LEC data had the effect of ameliorating a portion of the increase in the X-factor that would have otherwise occurred based solely upon the revised BLS economy-wide productivity growth figure. The

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35. California PUC, I.95-05-047, Transcript, September 27, 1995, at 212.

36. *Id.*, at 211-212.

37. Pacific Bell Responses to CCLTC First Set of Information Requests, Phase I, I.95-05-047, No. VIII.

38. California PUC, I.95-05-047, Transcript, September 27, 1995, at 201.

39. Interstate LEC revenues are approximately $25-billion annually. Thus, a 0.1% increase in the X-factor will translate into a $25-million decrease in the annual price cap rate adjustment. This effect will, of course, be cumulative from one year to the next; i.e., in the first year, the impact is $25-million, in the second year, it is $50-million, in the third year, it is $75-million, and in the fourth year, it is $100-million. Thus, over a four-year period, each 0.1% change in the X-factor represents roughly $250-million in LEC interstate revenues.

ECONOMICS AND
TECHNOLOGY, INC.

1993 Update had the effect of decreasing TFP by roughly .2%, which would be worth approximately $500-million in cumulative revenues to the LECs over the next four years.[40]

Significant changes in the data used and the information provided would have to occur in order to bring the Christensen/USTA study into compliance with the Commission's empirical requirements.

As discussed above, it is simply not possible for the Commission or interested parties to replicate and verify most of the key underlying data series that were used by Christensen Associates to calculate the TFP results produced by the Christensen/USTA study for several reasons:

(1) The Christensen/USTA study includes data that do not come from publicly available and verifiable series.

(2) The Christensen/USTA study aggregates data from nine individual LECs in a manner that cannot be audited or verified given the confidential proprietary treatment of that data.

(3) The updated Christensen/USTA study relies upon revised data series that are not documented.

These deficiencies are by themselves fully sufficient to warrant rejection of the Christensen/ USTA studies as a basis for determining the permanent X-factor in the FCC price cap program. That verification and replication are essential is confirmed by the obvious flaws and anomalies in the small fraction of the total data set that has been disclosed and for which no explanation has been forthcoming. In order to rectify these problems and comply with the Commission's empirical requirements and criteria for an X-factor adopted in a long-term price cap plan, significant changes in the data used in any TFP study and in the level of information provided to the Commission and interested parties would have to occur.

In later sections of this report, we discuss the elements of a proper TFP study in response to issues raised in the FFNPRM. In those later sections, we offer specific ways in

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40. The 1993 Update also had the effect of reducing the LEC input price differential vis-a-vis GDP-PI from 2.6% to 2.13%. Although USTA did not accept the inclusion of an input price differential in the calculation of the X-factor, this revision was clearly intended as a "hedge" against the possibility that the Commission would adopt the input price differential as recommended by Ad Hoc and by a number of other parties. From the original May 1995 study, the combination of LEC TFP and the input price differential would have produced an X-factor of 5.2% (before adding the 0.5% Consumer Productivity Dividend). With the revisions to both TFP (2.46%) and input price differential (2.13%) reflected in the January, 1995 submission, the corresponding X-factor would be only .4.6% (without the CPD), representing approximately $1.25-billion in cumulative LEC revenues over the next four years.

11

ECONOMICS AND
TECHNOLOGY, INC.

which some of the data problems inherent in the Christensen/USTA study (e.g., the use of internally-generated LEC TPI series and the use of total company data) could be corrected, and we quantify the effect upon the X-factor that would result were these corrections made. Other empirical shortcomings of the Christensen/USTA study can be rectified only with the provision of additional information from USTA, including the public release of individual LEC data series for all nine LECs included in the Christensen/USTA study and a comprehensive set of workpapers and any other data necessary to fully replicate and verify the study results pursuant to Paragraph 15 of the FFNPRM. To this end, The Ad Hoc Committee served a set of data requests on USTA seeking the full array of the underlying data used in both the revised and original Christensen/USTA studies as well as additional information needed to replicate Christensen's TFP results.[41] USTA provided some (but by no means all) of the needed information in its response dated November 28, 1995.[42] Still other empirical issues, such as the need to take into account hedonic effects upon capital input prices, may require further work to resolve, yet are critically important in arriving at a properly-specified X factor.

In a *Motion for Extension of Time* filed November 8, 1995 in this proceeding, USTA indicates that it "is in the process of developing a Total Factor Productivity Review Plan (TFPRP)." According to USTA, this TFPRP "will provide a formal means of displaying all the inputs and calculations necessary to develop the productivity offset" and "enable all the parties, including the Commission, to easily analyze the data ... and provide a format to demonstrate that the calculation of a TFP-based offset yields results that can be easily duplicated."[43] Display of inputs and calculations and the ability to duplicate results is certainly necessary in order to satisfy the Commission's criteria for a permanent X-factor. However, of even greater importance is the ability of interested parties and the Commission to obtain and verify the actual *data* used in the calculations. As discussed above, many of the problems with the Christensen/USTA study relate to empirical issues, such as the accessibility of data, validity of data, and confidentiality of data. Merely displaying inputs and calculations in a tariff review plan-type format does not address the serious substantive data problems raised in the FFNPRM.

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41. Information requests of the Ad Hoc Committee to USTA, dated November 10, 1995.

42. In particular, USTA provided copies of the data diskette and printouts containing the composite data series used in the productivity calculations for the USTA studies submitted to the Commission in May 1994 and in January 1995. However, as of this writing, USTA has responded to questions concerning reconciliation of various data used in the capital input analysis or seeking the underlying individual LEC data for each of the nine LECs incorporated in the composite data series used in the productivity calculations. See USTA *Ex Parte* Letter dated November 28, 1995.

43. Opposition to the Motion for Extension of Time of Ad Hoc Telecommunications Users Committee and Motion for Extension of Time of the United States Telephone Association, CC-Docket Nos. 94-1, 93-124, and 93-197, November 8, 1995, p. 4.

ECONOMICS AND
TECHNOLOGY, INC.

At a minimum, the TFPRP must include all data series provided by each of the participating LECs as well as all of the LEC composite series used in the TFP calculations. It must provide the manner in which the individual LEC data is weighted and combined to create the composite series. It must contained *detailed* methodological narratives as to how each of the participating LECs compiled, adjusted, revised, aggregated, or otherwise manipulated any of the data series that it furnished. To the extent that any of this work is outside of the supervision and control of Christensen Associates or USTA itself, the TFPRP must include statements explaining how each of the LECs performed its data analyses and documenting all assumptions underlying those calculations. For example, where "current" rather than "book" values are used (as in the 1984 base capital stock figures), the LECs should individually be required to provide detailed explanations as to how such "current" valuations were made, what specific technology and network architecture assumptions were incorporated into the analysis, whether the "current" values were based upon straight repricing of existing plant, functional replacement of plant using (then available) least-cost technology, data sources used in making such valuations, and other relevant information. The TFPRP should be structured so as to allow the Commission and interested parties to modify individual assumptions, replace proprietary data series with publicly available sources, adjust for quality effects to the extent these are ignored in LEC capital input price indices, and in general to test the sensitivity of the Christensen/USTA results to changes in underlying data, assumptions and computational methods. Anything short of that will not satisfy the Commission's explicit requirement, and will not rehabilitate what must otherwise be seen as a highly discredited foundation upon which USTA relies for its X-factor recommendations.

13

ECONOMICS AND
TECHNOLOGY, INC.

3 | TFP VS. ALTERNATIVE METHODS OF CALCULATING THE PERMANENT X-FACTOR

A properly-specified and supported TFP approach calculated using objective, verifiable data and which appropriately recognizes the effect of input price changes would provide an acceptable basis for calculating the X-factor in a long-term price cap plan; in the absence of an acceptable TFP measure, however, the Commission may need to continue to rely on alternative methods.

The Commission's tentative conclusion, as first indicated in the *First Report and Order*, and now reiterated in the *Fourth Further Notice*, "that a TFP approach should be used to compute the X-factor in the future,"[44] is a sound one, provided that the TFP approach selected by the Commission fully satisfies the Commission's general evidentiary criteria for the X-factor as set forth in the FFNPRM. To the extent the TFP approach is not properly-specified and supported, does not rely upon objective, verifiable data, or does not appropriately recognize the effect of input price changes on LEC output price levels — all problems that exist with both the original and revised Christensen/USTA studies — the Commission's general criteria will not be satisfied. The TFP approach with its direct measurement of productivity growth rates may be preferable to alternative approaches on economic and public policy grounds. However, a TFP approach that does not fully satisfy the Commission's general criteria offers no real advantages, and in fact has many disadvantages relative to other simpler methods of calculating the X-factor identified by the Commission in the FFNPRM, such as the historic revenue or historic price methods.

The Commission indicates its concern that using a moving average to update a TFP-based X-factor might require substantial resources to periodically recalculate the X-factor.[45] These concerns, while valid, are secondary when compared with the formidable problems underlying the calculation of the X-factor itself. The significant problems that exist with respect to Christensen's TFP Study exist independently of the use of a fixed TFP

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44. FFNPRM, para. 25.

45. *Id.*

15

vs. a moving average method. It is premature to consider use of a moving average approach given that the proper methodology for calculating the X-factor is still elusive.[46] Much work is yet needed in order to develop an acceptable TFP measure. An acceptable TFP model, among other attributes, will be reasonably simple, be based on accessible and verifiable data, and use sound methodologies for calculating input and output prices and quantities. Only after an acceptable TFP model is developed can the Commission begin to evaluate the relative benefits of a fixed TFP measure vs. a moving average TFP.

The presence of many problems in the Christensen/USTA approach has not escaped the Commission's attention. Indeed, in the FFNPRM the Commission raised numerous specific questions relating to data and methodology, seeking comments on essentially all components of the Christensen/USTA study. The analysis that follows addresses the questions raised by the Commission, focusing upon the identification of serious infirmities with the Christensen/USTA study and correspondingly of the significant changes that would be required in the study to produce an acceptable TFP model for use in calculating the X-factor in a long-term price cap plan. Where possible, we estimate the quantitative effect upon the X-factor that results from specific corrections to the Christensen/USTA study, or at a minimum, the direction of the bias that results from specific errors made by Christensen. Since even a small percentage change in the X-factor has a significant dollar impact on rates for interstate services, the sensitivity of Christensen's results to specific corrections or improvements will be highly significant and must be taken into account.

The results of our analysis demonstrate that once a number of key corrections are made to the Christensen/USTA study, the correct X-factor will be found to be considerably greater than the paltry 2.1% claimed by USTA and even the highest 5.3% value adopted by the Commission in the *First Report and Order*. As shown in Section 4 of this report, the X-factor for interstate LEC services (including the input price differential (IPD) and a 0.5% Consumer Productivity Dividend (CPD)) increases from 5.1% based on the "1993 Update" Christensen/USTA study to 9.9%. Failure to adopt these corrections will result in LEC overcharges in the range of $12-billion over a four-year period, creating unprecedented windfall profits for these companies.[47]

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46. A moving average of a flawed number is going to be a flawed number.

47. See footnote 39, *supra*, for an explanation of this calculation.

16

Output Index Issues

The Commission seeks comment on the reasonableness of Christensen's output price indices, noting that the construction of Christensen's indices do not follow conventional economic formulas and that price indices for local services, intrastate access, and long distance service appear to be based on an *ad hoc* method that the Commission finds difficult to replicate.[48] We agree with the Commission's findings. The empirical-related problems identified by the Commission with respect to the output index reflect the general problems with the data and overall approach used by Christensen as discussed in Section 2 of this Report. As found by the Commission, it not clear how the price indices used by Christensen to deflate revenues were derived. Moreover, to the extent public sources of price information, such as CPI indexes developed by the BLS for telecommunications services, are relied on to derive price indices to deflate revenues, those price indices are likely to overstate price growth and correspondingly to understate quantity growth. For example, as noted in a recent report by the Industry Analysis Division, the CPI for telephone services "has under weighted the dramatic reductions in toll rates that have occurred since 1984."[49] Another related problem with public sources of price data is their reliance on nominal "list" or tariff prices which fail to reflect the actual prices being paid for contract-based, discount, or non-tariffed services. Inasmuch as these prices will almost surely be lower than the published tariff rates, the use of tariff rates in calculating the annual change in LEC price levels will tend to produce an overstatement of the annual LEC price increase which, in turn, will have the effect of understating the growth in LEC physical output.

An alternative approach to Christensen's indirect method of measuring output by deflating revenue would be the use of physical output measures, such as minutes of use and lines. Such a method would offer the advantage of providing a direct measure of output that could be more readily replicated and avoid the need to use unverifiable and likely inaccurate price indices. In addition, such a method would alleviate problems associated with the categorization (and weighting) of outputs. In fact, in the case of *interstate* services (the subject of this proceeding and the purview of this Commission), switched access is the *dominant* component of output, representing some 64% of total LEC interstate revenues over the 1984 to 1993 period.[50] Output of switched access can be appropriately measured

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48. FFNPRM, para 26.

49. Susan E. McMaster and James Lande, Industry Analysis Division, Common Carrier Bureau, *Reference Book: Rates, Price Indexes, and Household Expenditures for Telephone Service*, November 1995, page 130.

50. See USTA Response to the November 10, 1995 Information Request of the Ad Hoc Committee, Question 1, "Annual Revenue Shares" Data. However, from revenue data provided by the price cap LECs with their *First*

ECONOMICS AND
TECHNOLOGY, INC.

in terms of minutes of use and lines.[51] If it is determined that more than one output dimension should be incorporated into an aggregate output index, revenue-weighted physical output measures of the principal interstate services could be used, and would still be far superior to Christensen's output price index method. Thus, switched access output could be measured in terms of minutes of use and lines, switched transport output could be measured in terms of minute-miles, and special access output could be measured in terms of voice-grade-equivalent circuit miles. Any direct output measurement along these lines, perhaps with further refinements as needed, would be far superior to continued use of the output price index method.

Input Index Issues: Capital

Cost of Capital

The Commission seeks comments on the appropriate measure of cost of capital and specifically whether Christensen's use of the Moody's Yield on Public Utility Bonds is appropriate.[52] As recognized by the Commission, Christensen's measure of the cost of capital is based solely upon the cost of *debt*. There would appear to be no valid economic rationale for relying solely upon the cost of debt.

The use of the cost of capital in the Christensen/USTA study is limited to the rental price formula.[53] From an economics standpoint, and consistent with the theory of efficient

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50. (...continued)
Report and Order compliance filing in May, 1995, it would appear that interstate switched access (including SLC) revenues may represent in the range of 75% of total LEC interstate revenues. See *Telecommunications Reports*, May 15, 1995, at 4.

51. If this approach is adopted, physical output growth can be determined by weighting minutes and line growth by the relative shares of traffic-sensitive (TS) and non-traffic-sensitive (NTS) costs, respectively.

52. FFNPRM, para 34.

53. The measurement of the capital input in the Christensen\USTA Study is based on the application of neoclassical capital theory which holds that the cost of the capital input is not reflected by the asset price of the capital input, but rather the annual flow of real capital services provided by the capital asset over time. The first step in this process is to construct annual user costs or rental prices for each of the six classes of capital assets identified in the Christensen Study. This so-called "implicit rental price" is intended to reflect the hypothetical price of renting the capital stock in a competitive market. The rental price formula used by Christensen depends on the rate of return or cost of capital, the rate of decay as reflected by the annual depreciation rate, various tax rates and tax rate components, and the economic reevaluation of the plant as reflected by the relevant asset price deflator or TPI. (See "Productivity of the Local Operating Telephone Companies Subject to Price Cap Regulation," Laurits

(continued...)

capital markets, the cost of capital or rate of return used in the rental price formula should be the expected or *ex ante* rate of return (alternative cost of funds plus a risk premium suitable to the industry) sufficient to attract capital to the industry.[54] Accordingly, the appropriate cost of capital for use in a TFP study would be a combination of debt and equity weighted by the LEC's (or LECs') debt/equity ratio.

One method of calculating a cost of capital that combines debt and equity is to use, as the Commission suggests, the Commission-prescribed rate of return in effect during each of the years analyzed in the TFP study. The problem with this approach, however, is that the Commission did not represcribe the rate of return annually. Thus, it cannot be assumed that the Commission's prescribed rate of return would be a valid measure of the external cost of funds facing the LECs in every year.

However, since the use of the cost of capital in the Christensen/USTA study is limited to the rental price formula, there is another adjustment that can be made to correctly reflect the debt/equity distinction. Such an adjustment is especially appropriate given Christensen's use of a debt-only cost of capital measure. In particular, under the U.S. tax code, interest payments on debt are tax exempt, whereas the return to equity holders is taxed. This distinction should be recognized in the calculation of the rental price of capital by adjusting the tax effect component of the rental price formula to correctly reflect the ratio of equity to total debt and equity.[55] As demonstrated in Section 4 of this report, the debt/equity adjustment produces a significantly higher X-factor result.

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53. (...continued)
R. Christensen, Philip E. Schoech, and Mark E. Meitzen, May 3, 1994, pages 7-8.) Having calculated rental prices for each of the six classes of capital assets, Christensen then obtains his measure of capital service flows as being the product of these rental prices times the relevant capital stock amounts (themselves calculated using the "perpetual inventory method" as discussed as a separate matter below). The final step is to aggregate the capital service flows for each of the six classes of assets into one index of capital input quantity, using the rental prices for the various types of capital input as components in their respective cost share weights.

54. See J.R. Norsworthy and Tsai, D.H. (forthcoming) Macroeconomic Policy as Implicit Industrial Policy, (Kluwer Academic Publishers, Norwell, Mass.), Chapter 3.

55. *Id.* The tax component of the rental price formula, $(1-\mu)$ as designated in "Productivity of the Local Operating Telephone Companies Subject to Price Cap Regulation," *op cit*, page 7, note 8, is appropriately adjusted to $(1 - \mu \varepsilon)$ where ε represents the ratio of equity to the total of debt and equity.

19

Depreciation

The Commission seeks comment on the appropriate depreciation rates to use in the TFP Study. In particular, the Commission asks whether it is more appropriate to rely on rates prescribed by the Commission vs. the "economic depreciation" rates selected by Christensen.[56] The Commission's prescribed depreciation rates are more appropriate, because they more accurately reflect depreciation rates applicable to the LECs and are consistent with the RORR benchmark upon which the price cap paradigm is constructed.[57]

The Commission's prescribed rates have been set based upon studies conducted by the LECs relating specifically to the capital assets used by the LECs in providing telecommunications services. The rates selected by Christensen are based upon a chain of studies conducted by various economists for business assets for the economy as whole:

* According to the FFNPRM, the rates employed by Christensen were taken from a study conducted by D. W. Jorgenson, entitled *Productivity and Economic Growth*;[58]

* The cited Jorgenson study indicates it relies on "economic" depreciation rates from a 1990 Jorgenson and Yun study, *Tax Policy and the Cost of Capital*;[59]

* Further research finds the referenced economic depreciation rates in a related work by Jorgenson and Yun, entitled *Tax Reform and the Cost of Capital*, published a year later in 1991 by the same publisher.[60]

* The depreciation rates in the 1991 Jorgenson and Yun study were in turn derived from a 1981 study by Hulten and Wykoff, *The Measurement of Economic Depreciation*, which used the "best geometric approximation approach for all assets distin-

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56. FFNPRM, para 38.

57. The use of any depreciation rates other than those prescribed by the Commission will produce a systematic bias that will lead to over- or under-earnings even if all other aspects of the price cap formula are correctly specified.

58. FFNPRM at 16, citing D.W. Jorgenson, "Productivity and Economic Growth," in *Fifty Years of Economic Measurement*, (E.R. Berndt and J.E. Triplett, eds., 1990), at 19-118 (Jorgenson).

59. Jorgenson, *op cit*, at 44, citing D.W. Jorgenson and Kun-Young Yun, *Tax Policy and the Cost of Capital*, New York: Oxford University Press, 1990.

60. D.W. Jorgenson and Kun-Young Yun, *Tax Reform and the Cost of Capital*, New York: Oxford University Press, 1991, pages 76-80.

20

guished by the Bureau of Economic Analysis (BEA) in constructing the U.S. national income and product accounts;"[61]

- The Hulten and Wykoff study referenced in both the Jorgenson and Jorgenson and Yun studies estimates the form and rate of economic depreciation using an econometric technique as explained in yet another 1981 Hulten and Wykoff study, *The Estimation of Economic Depreciation Using Vintage Asset Prices: An Application of the Box-Cox Power Transformation*;[62] and finally,

- The later-referenced Hulten and Wykoff study indicates that the Box-Cox Power Transformation regression technique was applied to data from the 1956 to 1971 time period.[63]

There are a number of serious problems with the underlying data upon which Christensen relied on in his study of LEC productivity. As evident from the above chain of references, the economic depreciation rates relied upon in the Christensen study of LEC productivity ultimately can be traced to a 1981 econometric analysis of data for the period 1956 to 1971 performed by two economists not specifically studying assets used by the telephone companies. The rates employed by Christensen are therefore based upon conditions from a much earlier time period than the post-divestiture time period of Christensen's study.

Furthermore, according to the Jorgenson and Yun Study, the asset categories applicable to the LECs (and specifically used by Christensen in his study of LEC productivity), including communication equipment and telephone and telegraph structures, belong to a third class of assets for which "little or no reliable information was available" to Hulten and Wykoff when they did their study.[64] Absent reliable information for this class of assets, Jorgenson and Yun indicate that Hulten and Wykoff made certain assumptions regarding depreciation rates based on "averages for assets in the first two groups," which they, Jorgenson and Yun,

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61. *Id.*, citing Charles R. Hulten and Frank C. Wykoff, "The Measurement of Economic Depreciation," in *Depreciation, Inflation, and the Taxation of Income from Capital*, ed. Charles Hulten, 81-225, Washington, D.C.: Urban Institute Press.

62. Hulten and Wykoff, *op cit*, citing Charles R. Hulten and Frank C. Wykoff, "The Estimation of Economic Depreciation Using Vintage Asset Prices: An Application of the Box-Cox Power Transformation," *Journal of Econometrics* 15, no. 3, April, 1981, pp.367-96.

63. Hulten and Wykoff, "The Estimation of Economic Depreciation," *op cit*, pages 389-394.

64. Jorgenson and Yun, *op cit*, p. 78.

maintained in their study.[65] These two groups of assets cover a wide range of BEA asset categories pertaining to the U.S. economy as a whole.[66] Jorgenson and Yun did make certain revisions to the depreciation rates from Hulten and Wykoff to incorporate what was at that time, "the most recent revision of asset lives by the BEA."[67] However, these revisions by Jorgenson and Yun appear to have had the effect of lowering the depreciation rates for asset categories applicable to the LECs. Of the three depreciation rates applied by Christensen to LEC capital assets, two represent reductions from the "old" depreciation rates for those same categories.[68] Thus, the depreciation rates relied upon by Christensen for the six categories of capital assets used by the LECs appear to be based not only upon pre-divestiture conditions, but conditions applicable to a wide range of BEA asset categories generally revised to incorporate longer lives.

By contrast to the "economic" depreciation rates used by Christensen, the LECs have regularly and consistently sought significant increases in depreciation rates for their capital assets over time, citing the high rates of technological change and changes in industry structure in the telecommunications industry. The Commission has recognized these changes and the connection between them and the acceleration of LEC depreciation.[69] As succinctly stated by the Commission, "the goal of the depreciation prescription process is to

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65. *Id.* In particular, Hulten and Wykoff "assumed rates of depreciation equal to 1.65 times declining balance rates based on BEA asset lifetimes for equipment and 0.90 times these rates for structures."

66. Appendix A provides a complete listing of the BEA asset categories utilized by Jorgenson and Yun, numbered sequentially from 1 to 51. The two groups of assets upon which assumptions for the third group of assets (which included the categories used by Christensen) were based include asset classes: 6, 7, 9, 11, 13, 20, 21, 28, 29-32 (in Group 1), and asset classes 14, 22, 25, 26, 27, 35, 36, 37, 38, 43, and 44 (in Group 2). *Id.*

67. *Id.*, p. 78.

68. Specifically, Christensen applies the "new" rate for the BEA category "communications equipment" of 11.00% to LEC investment in central office equipment, transmission equipment, and information origination/termination equipment, whereas the "old" rate listed for communications equipment is 11.79%. Similarly, Christensen applies the "new" rate for the BEA category "telephone and telegraph structures" of 2.25% to LEC investment in buildings and cable and wire, whereas the "old" rate listed for telephone and telegraph structures is 3.33%. See D. W. Jorgenson, *Productivity and Economic Growth*, op cit, Table 3.6, page 44, or the identical to the table appearing in Jorgenson and Yun, *Tax Reform and the Cost of Capital*, op cit, Table 3.19, pages 79-80, reproduced as Table A1 in Appendix A to this report. As shown in Table A1, the BEA asset classification scheme includes some 50 categories of non-residential assets. Table A1 provides a complete listing of the BEA asset categories and the depreciation rates identified in the Jorgenson and Yun study and used by Christensen. The third depreciation rate identified as being used by Christensen, a rate of 15.46% applied to LEC investment in general support equipment, does not appear listed in either of the Jorgenson studies and is not explained in the Christensen study.

69. Report and Order, CC Docket 92-296, In the Matter of Simplification of the Depreciation Prescription Process, October 20, 1993, para. 56.

accurately reflect the actual rate of plant retirement."[70] It has long been the practice of this Commission to consider LEC-specific conditions in authorizing depreciation rates and methods. The extensive body of evidence and experience relating to this issue invalidates the use of any "economy-wide" depreciation conditions.

According to the Commission, the depreciation rates selected by Christensen are significantly lower than rates prescribed by the Commission.[71] The prescribed rates, however, are historically even lower than those requested by the LECs, and the LECs have been subject to depreciation reserve deficiencies.[72] Thus, to the extent prescribed rates are reasonable reflections of the fundamental economic conditions of capital recovery facing the LECs, it would be incorrect to rely upon rates selected by Christensen that do not reflect those fundamental economic conditions and that portray a pattern inconsistent with that which the LECs have proposed and the Commission has adopted. For these same reasons, it would be appropriate for the Commission to require that depreciation rates for future updates be within the bands established by the Commission for streamlined treatment.

In the TFP model, depreciation enters into the calculation of both the TFP and input price differential components of the X-factor. The effect on results of using Commission-prescribed depreciation rates cannot be determined *a priori*, but rather is an empirical issue. However, to the extent the Christensen/USTA study understates depreciation rates relative to prescribed rates in the manner found by the Commission, Christensen's results can be shown to be biased downward; as demonstrated in the next section of this Report, the use of higher depreciation rates consistent with Commission prescriptions produces a significantly higher X-factor result.

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70. *Id.*

71. FFNPRM, para. 38, note 59. As set forth in note 59:

Based on the depreciation rate as prescribed by the Commission for the period from 1984 to 1992, the average composite depreciation rate of the BOCs, GTE, and SNET was 7.1%. For that period, the average composite depreciation rate in USTA's February 1, 1995 TFP study for those LECs was 5.7%.

Thus, according to the Commission (we have not been able to replicate the Commission's calculations), the depreciation rates used by Christensen are some 20% to 25% lower than those prescribed by the FCC on the basis of average composite depreciation rates.

72. See Report and Order, CC Docket 92-296, In the Matter of Simplification of the Depreciation Prescription Process, October 20, 1993, para. 51. The Commission specifically acknowledges that "in the past, our depreciation practices and rates may have lagged behind changes in the telecommunications markets."

Capital Stock/Economic Stock Adjustment Factors

The Commission seeks comments on the most reasonable method to estimate capital stock, and in particular, on the most appropriate methods and data sources for determining replacement values.[73] The Commission also seeks comment on the economic stock adjustment factors used in the Christensen/USTA study to derive the capital stock replacement values. The Commission's concerns with respect to the reliability of Christensen's method is underscored by the very large swing in the capital replacement value data series that occurred between the original and revised Christensen studies. The data problems so evident with the capital replacement value series reflect the general problems with the data and approach used by Christensen as discussed in Section 2 of this report, and provide further evidence of the inappropriateness of relying upon the Christensen/USTA study in a long-term price cap plan.[74]

Indeed, replacement or reproduction values are fundamentally "soft" figures that cannot be directly gleaned from LEC accounting data, yet the values computed for them have a material and decisive impact upon the resulting TFP value. Also, the Commission does not have the data necessary to replicate the calculations or to audit or verify the underlying data and assumptions that were used, or to test for consistent and unbiased application of those assumptions. As discussed in Section 2 of this report, Christensen himself cannot explain, for example, how the values for 1984 were calculated, who did the calculations, or what engineering assumptions were used to determine "reproduction cost." The conversion from book to reproduction cost was made by the individual LECs and not by Christensen Associates, and furthermore, Christensen does not know what specific methodology was used to accomplish these conversions or, for that matter, whether they were even done consistently from one LEC to the next. We do know that there were apparently major problems with at least some of the figures used in the May, 1994 study, because of the wild swings in some of the individual LEC numbers in the "1993 Update."[75] The existence of these problems confirm the inappropriateness of relying upon the type of data and analysis methodologies used in the Christensen/USTA study for a long-term price cap plan.

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73. FFNPRM, para.41-43.

74. See, e.g., November 10, 1995 Information Request of the Ad Hoc Committee to USTA, Questions 3 and 4. No responses to these requests had been provided by USTA as of the date of this writing. In USTA's *Ex Parte* letter to the Commission, dated November 28, 1995, concerning its response to the Ad Hoc Information Request, USTA indicated only that it is "considering whether to purchase consultant services in this regard."

75. For example, NYNEX reduced its 1984 base capital stock by some $13.5-billion from the original May 1994 Christensen/USTA study to the January 1995 "update." See footnote 31, *supra*.

ET ECONOMICS AND
TECHNOLOGY, INC.

There are alternatives to using unauditable replacement capital price data. In particular, historical cost data, and specifically the net book value of plant in service, is available in ARMIS or from the U.S. Department of Commerce, Bureau of Economic Analysis (BEA),[76] and could be used for this purpose.

Investment

The Commission notes similar problems with the data on investments (plant additions) that was used in the Christensen/USTA study, and has requested USTA to provide more detailed information concerning the sources of the data and of the errors corrected in the revised study.[77] The investment series used in the TFP study must come directly from publicly available sources, otherwise results can be easily manipulated. Until USTA provides the additional level of detail sought by the Commission, further analysis of issues surrounding the investment data series is premature.

Telephone Plant Indices (TPIs)

Quite appropriately, the Commission expresses concern that the TPIs used in the Christensen/USTA study to deflate capital asset categories were calculated by the LECs and were thus not subject to external controls or validation.[78] The Commission expresses particular interest in whether the TPIs can be calculated in a timely manner and from publicly available data, and whether the Commission can rely upon present methods of calculating TPIs for calculating the X-factor. The Commission has asked the LECs to provide more detail concerning the calculation of the TPIs. Once again, the data problems cited in the FFNPRM with respect to the TPIs reflect the general problems with the data and approach used by Christensen as discussed in Section 2 of this report, and provide further evidence of the inappropriateness of relying on the Christensen/USTA study in a long-term price cap plan. As discussed in Section 2 of this report, the TPIs were based upon highly confidential information from the individual LECs, and Christensen was not provided with any

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76. See, U.S. Department of Commerce, Bureau of Economic Analysis, *Fixed Reproducible Tangible Wealth in the United States*, 1925-89. Washington, DC: U.S. Government Printing Office, January 1993. The estimates in this publication cover the stock of privately owned and government-owned durable equipment and structures and of durable goods owned by consumers in the United States and are "consistent, definitionally and statistically with the national income and product accounts (NIPA's)." (page M-1). "Several measures of gross and net stocks, depreciation, and discards that reflect different valuations — historical cost, constant cost, and current cost" are shown in the publication. (page M-3)

77. FFNPRM, para. 44.

78. *Id.*, para. 45.

25

ECONOMICS AND
TECHNOLOGY, INC.

supporting documentation concerning the development of the TPIs. Of particular concern was the fact that Christensen did not appear to have applied any sort of reality or sanity check on the data that was furnished to him. As we noted earlier, he testified (in California) that he had no specific basis upon which to conclude that the anomalous TPI for Bell Atlantic, which showed a 49% increase in the prices for central office equipment (COE) plant over the study period as against price *decreases* for the other LECs, was accurate. He merely accepted Bell Atlantic's representation that it was.

It is important to emphasize that the TPI series have a critical impact upon the results of the Christensen/USTA estimate of LEC TFP.[79] As we discuss in Section 4 of this report, we have been able to assess the sensitivity of the TPI values to the resulting TFP estimate, and have found that adjustments to the TPIs have a material impact upon the TFP result.

USTA's reliance upon these confidential, proprietary, unverifiable, internally-generated price indices is particularly suspect in view of the fact that there are alternative price deflator data available from other, public sources, including the Bureau of Economic Analysis (BEA) and Bureau of Labor Statistics (BLS), that could be used in lieu of the unauditable LEC TPI series. The BEA/BLS data offer the critical advantage of being compiled by an objective, independent source. Appendix B to this report presents the BEA/BLS price deflator series that track categories of LEC investment, and compares those data series to the TPIs used in the Christensen/USTA study. The BEA assets categories we have selected match those used by Christensen for depreciation rates.[80] Because the TPIs have a significant effect upon the calculation of the X-factor under Christensen's approach, use of the BLS data in lieu of the LEC TPI data will produce different X-factor results. As demonstrated in the next section of this Report, the substitution of the BLS price deflator series for the LEC TPI data produces a significantly higher X-factor finding.

As discussed below, further refinement to the price deflator data used to calculate the X-factor in a long-term price cap plan is required to reflect hedonic price changes which account for changes in quality and/or capacity of the plant in each category. Such adjustments are especially necessary for the types of capital inputs used in the telecommunications industry, i.e., inputs containing computer chips, digital electronics, fiber optics, digital

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79. Christensen uses the "composite" TPI series (compiled from individual LEC TPIs) for each plant category to deflate annual dollar expenditures to constant 1984 dollars. Thus, inaccuracies in the TPIs will lead to erroneous capital input quantities, which are derived from the current dollar expenditure amounts. Hence, inaccurate TPIs will produce correspondingly inaccurate TFP, input price differential, and X-factor results.

80. See footnote 68, *supra*. Our criticisms of Christensen's choice of depreciation rates were not related to his choice of BEA asset categories to apply to his six LEC plant categories, but rather the fact that the depreciation rates presented in the studies that Christensen relied upon for the selected BEA asset categories were based on data from an earlier time period and from a wide range of other asset categories pertaining to the economy as a whole.

ECONOMICS AND
TECHNOLOGY, INC.

switching equipment, and other high-technology items, whose specifications and characteristics have evolved rapidly over time. For these types of inputs, the adjustment of price indexes to account properly for changes in quality and/or capacity over time is a very significant issue and, as discussed later in this section, one that the government is now dealing with. While this report does not develop specific hedonic adjustments to use in the calculation of the X-factor, as discussed below, research in related industries such as the computer industry provides evidence that hedonic price adjustments for LEC inputs would have the effect of substantially reducing input price growth for the LECs. Sensitivity analysis of Christensen's results indicates that incorporation of hedonic price adjustments would result in a significantly higher X-factor.

Perpetual Inventory Method/Implicit Rental Price

The Commission seeks comment on the validity of the perpetual inventory method used by Christensen. Under this method, capital services are imputed from the capital stock rather than from capital consumption.[81] The Commission also seeks comment on the related issue of the implicit rental price. Under the perpetual inventory method, the capital stock is multiplied by the implicit rental price to arrive at the value of capital services.

There is no inherent problem with Christensen's use of the perpetual inventory method, and the formula, while complex, is easily programmed for spreadsheet use.[82] As discussed in many contexts above, the problem once again lies in the data used in the Christensen/USTA study. The construction of the implicit rental price includes the cost of capital, the depreciation rate, various tax rates, and the TPI. Therefore, the problems discussed above with the data used by Christensen for cost of capital, depreciation, and TPIs affect the validity of the implicit rental price and consequently the reliability of the perpetual inventory method.

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81. FFNPRM, para. 46.

82. As discussed in Section 4 of this report, see footnote 158, *infra*, software is also available which effortlessly calculates capital stock series based upon the perpetual inventory method.

Input Index Issues – Labor

The Commission seeks comments on a number of different aspects regarding the development of the labor index in the Christensen/USTA study.[83] The Commission notes a particular concern about how post-employment benefits (OPEB) costs, and other accounting rules changes, might affect the labor index.

Analysis of the updated labor expenditure data series from the Christensen/USTA study confirms the need for adjustments relating to OPEB and other one-time events. For example, there is a dramatic increase in labor expenditures between 1992 and 1993. The principal source of the increase is in the benefits area — in particular, management benefits increased by some 43% from 1992 to 1993. This is likely due to various "golden handshakes" offered to encourage early retirements and that are included as part of expensed benefits due to restructuring efforts and force reductions, as well as the OPEB accounting change mentioned by the Commission. "Golden handshake" payoffs should not be charged to the single year in which they are paid, but should be amortized into the future over some number of years. Christensen admitted during cross-examination in California that some of these types of expenses are included in the labor expenditure data.[84] Similarly, OPEB-related accruals should be amortized back, since the SFAS 106 revision represents a correction for the failure to accrue these costs as the obligation to pay them was incurred. Productivity measurement rules of the Interstate Commerce Commission (with which Christensen has been involved) require such amortization treatment.[85]

The incorrect "current" treatment of benefits creates a systematic upward bias in the growth of the labor input over time — particularly when the 1993 data is included — which has the effect of understating the X-factor. At a minimum, the failure to amortize OPEB and "golden handshake" payments incorrectly increases the apparent growth in LEC input prices as well as labor's share in the input mix, reducing the apparent input price differential. It also appears that this misstatement of labor costs results in an overstatement of labor input growth rates and hence an understatement of TFP.

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83. *Id.* para. 52.

84. California PUC, I.95-05-047, Transcript, September 27, 1995, at 264.

85. *See*, USTA *ex parte* filing, CC Docket 94-1, December 29, 1994, transmitting Christensen Associates documents on Interstate Commerce Commission (ICC) railroad cost adjustment factor (RCAF).

Input Issues – Materials

The Commission seeks comment on whether it is preferable to construct a price index for materials directly instead of using Christensen's method of deflating material costs by the GDP-PI.[86] From a theoretical perspective, it would be preferable to construct an index that provided a direct measurement of the quantity of materials. To the extent this may not be practical due to data limitations, at a minimum, more careful consideration should be given to the choice of deflator used to construct the material index. The GDP-PI does not necessarily reflect the price growth of materials used by the LECs. In addition, as discussed further below, the GDP-PI is subject to quality change bias because it relies upon price series which do not reflect quality-adjusted price changes.

Input Price Adjustment

The Commission seeks comment on all analyses and conclusions regarding estimation and use of the input price differential: What is the most reasonable way to account for changes in LEC input prices for use in a TFP approach to calculating the X-factor;[87] whether the long-term trend of the input price differential is zero;[88] whether the trend in LEC input prices has changed since divestiture;[89] whether an X-factor should be based upon the input price differential data from the same period as the TFP study;[90] whether the input price differential should be calculated using data from the Christensen/USTA study;[91] whether there are other sources of LEC input price data that would be preferable to the Christensen/USTA study;[92] and whether the Commission, USTA, or some other entity could construct this index?[93]

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86. FFNPRM, para. 53.

87. *Id.*, para. 56.

88. *Id.*, para. 57.

89. *Id.*, para. 57.

90. *Id.*, para. 58.

91. *Id.*, para. 59.

92. *Id.*, para. 60.

93. *Id.*, para. 60.

ECONOMICS AND
TECHNOLOGY, INC.

An input price adjustment is a critical component of a properly-specified X-factor adjustment.

In the two ETI reports submitted in the first phase of this proceeding, we demonstrated that the correct calculation of a TFP-based X-Factor must reflect the historic post-divestiture LEC productivity growth rate adjusted to recognize the decreasing real price of LEC inputs, and explained why failure to incorporate an input price adjustment based upon post-divestiture conditions would result in an understated productivity offset and a correspondingly excessive annual price cap rate adjustment, creating a direct and inappropriate transfer of wealth from ratepayers to the LECs.[94] The FCC, in its *First Report and Order*, correctly found that the X-factor should include an adjustment to reflect differences in LEC input prices. As succinctly stated by the Commission:

> If the trend in LEC input costs is consistent with the performance of the national economy as a whole, that trend should be reflected in the GNP-PI factor used to adjust PCIs annually. *But, if the inflation factor does not accurately reflect changes in the carrier's input costs, an X-factor based on productivity changes alone will not capture the full extent of the differences between changes in LEC unit costs and the economy-wide inflation adjustment.*[95]

In competitive markets, any differential in the cost of industry inputs vis-a-vis the economy-wide inflation rate will be flowed through in the price of the industry's outputs in addition to any productivity gains being experienced within the industry, *and this will occur even if there are no other productivity gains.* While the effects of productivity and input prices operate in similar ways in competitive markets, they are distinct components and their respective impacts upon the price of a firm's product are cumulative, a conclusion reached both by ETI and by FCC Common Carrier Bureau economists C. Anthony Bush and Mark Uretsky.[96]

In the price cap system, input price changes are supposed to be captured through the use of an external inflation index, such as the GDP-PI, which is then offset to capture LEC

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94. Economics and Technology, Inc., *LEC Price Cap Regulation: Fixing the Problems and Fulfilling the Promise*, May, 1994; *An Empirical Estimate of the LEC Price Cap "X-factor" based upon Historic National LEC Productivity and Input Price Trends*, June, 1994.

95. *In the Matter of Price Cap Performance Review for Local Exchange Carriers*, FCC CC Docket No. 94-1, *First Report and Order*, Released April 7, 1995 (FCC Price Cap Review decision), paras. 160-161 (emphasis supplied).

96. See ETI June 1994 Study, at 5-7; also see, C. Anthony Bush and Mark Uretsky, "Input Prices and Total Factor Productivity," ("Bush/Uretsky analysis"), *First Report and Order*, Appendix F, at 1.

productivity gains reflective of historical experience. However, because the GDP-PI is a measure of *output* price changes and not input price changes, the GDP-PI must be converted into an input price index.

In the case of the telecommunications industry, LEC input prices are growing far more slowly than input prices confronting the overall economy. The phenomenon of slower growth in input prices in the telecommunications industry is due, in part, to the substantial productivity and technological gains being experienced in those segments of the telecommunications industry that supply equipment and other capital resources to the LECs, as well as to the capital intensiveness of the local exchange telephone business and telecommunications generally. Accordingly, the appropriate way to capture LEC input price changes is by including an input price differential in the X-factor formula that accurately reflects the lower input cost conditions experienced by the LECs. Failure to capture the appropriate input price differential in the X-factor creates a windfall gain for the price cap LECs in the amount of that differential, something that could not occur in a competitive market.

It is important to note that all parties in the price cap review proceeding, including USTA and its economic consultants, Christensen and NERA, appear to agree with the fundamental principles that in competitive markets changes in output prices reflect changes in input prices as well as changes in TFP, and that in order to replicate the results of a competitive market, the X-factor must reflect input price changes as well as TFP changes.[97] The problem with USTA and its consultants, however, is that having conceded these basic principles, they go on to argue unconvincingly that the X-factor should ignore post-divestiture measurements of LEC input price changes.[98] Specifically, they contend that the X-factor should incorporate the long-run difference between LEC and economy-wide input prices, which they claim to be zero (based upon 30-40 year trends, not upon data limited to the post-divestiture period).[99] Indeed, rather than recognizing LEC input price growth as *below* the economy-wide inflation rate, USTA's assumption that the input price differential is zero leads to formulaic machinations by USTA that have the effect of setting LEC input price growth *above* the economy-wide inflation rate.[100]

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97. See Bush/Uretsky at 1.

98. They also ignore important hedonic (i.e., quality-related) effects on LEC input prices, which if taken into account, would show a lower rate of price decline for LEC inputs vis-a-vis unadjusted price index series.

99. See USTA *Ex Parte* Filing to the FCC in CC Docket 94-1 dated February 1, 1995, at 9-10.

100. USTA's economic consultants asserted that the proper measure of the X factor over the 1984-92 period was 2.1%, or the difference between the LEC TFP growth of 2.4% and US economy-wide TFP growth of 0.3. This construct assumes (without proof) that LEC inputs do not benefit from economy-wide productivity growth, and are therefore experiencing price growth that exceeds GDP-PI by the aggregate economy-wide productivity growth

(continued...)

The LEC input price differential (vis-a-vis GDP-PI) should be incorporated into the X-factor on the basis of post-divestiture conditions (the same period as the TFP Study) and not on long-term historical experience.

Fundamental industry changes took place at the time of the break-up of the former Bell System, rendering pre-divestiture experience largely non-comparable to conditions in the post-divestiture period. In particular, the telecommunications equipment market has become highly competitive in the post-divestiture environment, since the MFJ's "manufacturing restriction" was imposed and Bell Operating Companies could no longer purchase inputs internally, but instead had to acquire inputs at arm's length prices from outside suppliers. Hence, pre-divestiture input price data is not comparable to post-divestiture input price data.[101]

In addition to the important structural changes that occurred in the telecommunications industry specifically, general principles of competitive markets support the concept of relying upon a short-term input price differential. In a competitive market, the relevant time frame for reflecting any input price effects is clearly the short run. In competitive markets, individual firms react to the prices that they currently pay (and that their competitors also confront) for their inputs. The long term trend in the price of inputs is essentially immaterial. For example, the local gas station raises the price of a gallon of gasoline by 3 cents in response to a price hike by its supplier, and because it knows that the competing gas station on the next block is facing the same situation. The fact that gasoline prices may be trending upward by so-many-cents a gallon per year over a 30-year time frame is entirely immaterial to the price-setting process that is employed by an individual firm.

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100. (...continued)

rate. In other words, if GDP-PI, which is a measure of *output* price growth, is increasing at an average of 3.7% annually, and as a measure of *output price* growth reflects the economy-wide productivity growth rate of 0.3%, then economy-wide input prices must (they reason) be growing at 3.7% *plus* 0.3%, or 4.0%. In fact, LEC input prices are growing at only 1.4%; therefore, the Christensen/NERA analysis has the effect of understating combined LEC and supplier productivity growth by some 2.6% [i.e., 4.0% minus 1.4%], without reflecting any of the other corrections that must be made and that are quantified in Section 4 of this report.

101. According to one study, price indices for telephone company switching equipment are said to show "markedly greater decline after January 1, 1984, when AT&T's ownership of operating companies expired," all of which suggest to the author that "market structure has been a chief determinant of technical innovation." See Kenneth Flamm, "Technological Advance and Costs: Computers versus Communications," in Robert W. Crandall and Kenneth Flamm, Eds. *Changing the Rules: Technological Change, International Competition, and Regulation in Communications*, The Brookings Institution/Washington, D.C., 1989, page 5.

32

ECONOMICS AND
TECHNOLOGY, INC.

Hence, even if Christensen/NERA were factually correct in their portrayal of LEC input price movements, which they are not, the relevant, competitive outcome input price movements are necessarily those that occur in the short-term. And by their own admission, short-term LEC input prices have risen and continue to rise well short of the economy-wide inflation rate. USTA's rejection of an input price differential based upon the post-divestiture experience is totally at odds with the irrefutable facts that (1) Dr. Christensen's own study develops and incorporates the very same post-divestiture LEC input price data in the calculation of the LEC TFP for that same period, and (2) LEC input price data for the post-divestiture period shows a clear pattern of input price growth that is much smaller than the annual GDP-PI growth rate.

The issue of relying on short-run (post-divestiture) versus long-run data to forecast the future trend in LEC input prices was specifically analyzed by Bush and Uretsky.[102] Based upon numerous statistical tests of the data, Bush and Uretsky confirmed that pre-divestiture input price conditions should be discarded and that the X-factor should include an input price adjustment derived from Christensen's TFP data for the same period as Christensen's measure of LEC TFP:

> Based on these considerations, we believe that an input price differential based on long-run, pre-divestiture data is not a reasonable basis on which to calculate the input price differential for the post-divestiture period. We believe that the input price differential for the post-divestiture period should be calculated using post-divestiture data. In particular, we believe that the input price differential for the 1984-1990 period should be based on data from that period.[103]

Bush and Uretsky also addressed and dismissed USTA's assertions that short-run (i.e., post-divestiture) measures of the input price differential are inaccurate and therefore should not be relied upon in calculating the X-factor. They concluded:

> Based on the record before us, we have no reason to conclude that the measurement problem that NERA describes affects the calculation of input price differential for the 1984-1990 period.

> In summary, USTA's economic consultants' descriptions of problems in measuring changes in post-divestiture input prices fails to convince us that

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102. See Bush/Uretsky at 11-14.

103. *Id.*, Appendix F, at 14.

ECONOMICS AND
TECHNOLOGY, INC.